

## Section 5

# Preparer/Promoter Penalties

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The Tax Reform Act of 1976 provided the IRS with penalty and enjoinder authority to more effectively monitor income tax return preparation. TEFRA 1982 provided the IRS with penalty and enjoinder authority to more effectively monitor promotion of abusive tax shelters. These provisions are designed to promote a high standard in the preparation of returns for compensation and also address the problem of fraudulent, unscrupulous, or incompetent preparers.

Return preparer penalties relate to IRC sections 6694, 6695, 6700, 6701, 6713, 7407 and 7408. In the interest of overall sound tax administration, the Service focuses on preparer conduct and applies sanctions whenever warranted. Penalty assertion is the key enforcement vehicle for noncompliant preparers.

### **What is the difference between a preparer and a promoter?**

A return preparer is any person who prepares for compensation, or employs another person to prepare for compensation any tax return or claim for refund of income taxes.

A promoter is any person who organizes or sells any plan or arrangement and who makes statements with respect to securing any tax benefit by reason of participating in such plan or arrangement.

### **What are preparer penalties?**

Preparer penalties are generally categorized as conduct (IRC 6694(a) and (b)) or identification penalties (IRC 6695).

The conduct penalty of \$250/return under IRC 6694(a) applies if any part of an understatement of a taxpayer's liability is due to a position that has no realistic possibility of being sustained on the merits and the tax return preparer knew or reasonably should have known of such position. An unrealistic position is described in the Regulations as a position that has no realistic possibility of being sustained on its merits. The IRC section 6694(a) penalty does not apply if the position taken is not frivolous and is adequately disclosed.

The conduct penalty of \$1,000/return under IRC 6694(b) applies if any part of an understatement of a taxpayer's liability is due to a willful attempt to understate the income tax liability or due to any reckless or intentional disregard of rules or regulations. The willfulness penalty applies if the preparer takes a position on a return, which he knows, or is reckless in not knowing, is contrary to a rule or regulation. The preparer's conduct is compared to a standard of conduct that a reasonable preparer would demonstrate in the same situation.

## Section 5

### Preparer/Promoter Penalties

---

The identification penalties under IRC 6695 are as follows:

§ 6695(a)	Failure to furnish a complete copy of the return to the taxpayer.
§ 6695(b)	Failure to sign the taxpayer's return, if required to do so.
§ 6695(c)	Failure to furnish the preparer's identifying number or that of his firm.
§ 6695(d)	Failure to retain a list or copies of returns filed.
§ 6695(e)	Failure of employers to retain a record of the name, EIN, and place of work for each preparer employed by them.
§ 6695(f)	Negotiation of a taxpayer's refund check.
§ 6695(g)	Failure to Be Diligent in Determining Eligibility for Earned Income Credit

The penalty for violating subsections (a) through (e) is \$50 per failure; for subsection (f) it is \$500 per check and (g) is \$100 per failure.

In addition, IRC 6713 provides a penalty of \$250.00 for each unauthorized disclosure or use of information connected with a tax return or the preparation of a tax return. The penalty may be asserted against a tax return preparer or any person providing services in connection with the preparation of a return.

Finally, under IRC 7407 the IRS has the power to seek an injunction prohibiting an income tax preparer from preparing returns in the future. There are two provisions in section 7407, one prohibits the preparer engaging in the conduct listed in Section 7407 and the other prohibits the preparer from preparing returns all together. Generally the Service seeks to enjoin bad preparers under both provisions of IRC 7407.

Income tax return preparer practices that may cause the Service to initiate injunctive action:

- Conduct subject to IRC sections 6694 and 6695 penalties;
- Conduct subject to criminal penalties;
- Misrepresentation of the return preparer's eligibility to practice before the Service, or his or her experience and education as an income tax return preparer;
- Guarantee of payment of a tax refund or of allowance of a tax credit;
- Other fraudulent or deceptive conduct that substantially interferes with proper administration of the Internal Revenue laws.

**What are promoter penalties?**

## Section 5

# Preparer/Promoter Penalties

---

Promoter penalties are generally categorized as promoting abusive tax shelters (IRC 6700) or aiding/abetting the understatement of a tax liability of another person (IRC 6701).

### PENALTY FOR PROMOTING ABUSIVE TAX SHELTERS

IRC 6700 provides for a penalty applicable to persons who promote abusive tax shelters. The amount of the penalty is the lesser of \$1,000 per activity or 100% of the income derived from the activity. The actual organization of the tax shelter itself is considered to be a separate activity, and subsequent sales of interests in the tax shelter are separate activities. Therefore, the total amount of the penalty can be staggering. These penalties are in addition to other penalties provided by law.

The penalty is applicable to two distinct types of conduct:

1. Making a false statement with respect to the allowability of any deduction or credit, the excludability of any income or the securing of any other tax benefit by reason of participating in the plan or arrangement, which the promoter knows is false or fraudulent.
2. Making a "gross valuation overstatement" as to any material matter in connection with the organization or sale of an interest in the shelter.

### AIDING AND ABETTING PENALTY

IRC § 6701 provides for a \$1,000 penalty per violation for persons who knowingly aid and abet in the understatement of the tax liability of another person. The penalty is applicable if the following three conditions are met:

1. The person aids or assists in, procures or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim or other document in a tax matter; and
2. Knows (or has reason to know) that such portion will be used in connection with any material matter arising under the internal revenue laws; and
3. Knows that such portion (if used) would result in an understatement of another person's tax liability.

Other promoter penalties include the following:

- IRC 6707 imposes a penalty for failing to file or timely file Form 8264 Application for Registration of a Tax Shelter, or for providing false or incomplete information.

## Section 5

### Preparer/Promoter Penalties

---

- IRC 6708 imposes a penalty for failing to maintain and make available lists of investors.

Finally, IRC 7408 provides for an injunction against a promoter of an abusive tax promotion from further promotion of that scheme. Conduct that is subject to either the IRC 6700 or 6701 penalty may warrant an injunction against a promoter under IRC 7408.

#### Referrals to the Director of Practice

When the following penalties are asserted against a practitioner, an information referral to the Director of Practice is mandatory:

- IRC sections 6695(f), 6700, and 6701.
- IRC sections 6694(a) and (b) penalties when closed agreed by the examiner or sustained in Appeals, or closed unagreed without Appeal contact.
- IRC section 7407/7408 when action is taken to enjoin preparers or promoters.

#### When is a preparer subject to promoter penalties?

A promoter penalty may generally be imposed in addition to any other penalties imposed, except that the IRC 6700 penalty may not be assessed with respect to any document for which an IRC 6701 penalty is assessed.

A return preparer may be subject to a promoter penalty under IRC 6701, Penalty for Aiding and Abetting Understatement of Tax Liability, if the return preparer aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim or other document which results in understatement of tax. IRC 6701 applies when the preparer relies upon an abusive tax scheme to generate the unallowable tax benefits.

Accordingly, with respect to an abusive tax scheme, the return preparer could be subject to the \$1,000 conduct penalty under IRC 6694(b) as well as the \$1,000 promoter penalty under IRC 6701 for each return prepared for each taxpayer/investor for each tax year.